

**C**urrency exposure. For pension funds, or any investor with international investments, it's always going to be there. It's by no means insignificant either; with an increasingly global outlook, many pension fund portfolios will have a large percentage of international holdings. It's what pension funds choose to do about this exposure that matters.

As Mesirow Financial, head of portfolio management and research, currency management, Uto Shinohara, CFA, notes: "As the world has become more interconnected, pension funds have increased their allocations towards international investments in search of more opportunity and to diversify their portfolios."

These foreign investments, he says, include a currency component as a by-product, as performance is comprised of both the asset return and the currency return. Of course, as Shinohara says, there are risks associated with currency exposure, which sees funds employing various hedging strategies to manage such risk. "Currency risk management strategies span the risk spectrum, from passive hedging to dynamic hedging, depending upon the risk appetite and return goals of the pension fund," he adds.

However, pension funds should not just look at currency as a risk that needs to be managed, and many don't. Shinohara says that funds will often include return-seeking currency strategies in their alternatives sleeve, as currency has shown to be uncorrelated to the major asset classes.

### **An age-old debate**

It's an age-old debate; is currency an asset class in its own right? Sweden's Sjunde AP-fonden (AP7) head of fixed income, FX and alpha, Pontus von Essen, says his fund does



### **INVESTMENT**

**Whether welcome or not, currency exposure is a guarantee for any pension scheme with international investment exposure. Natalie Tuck looks at how Europe's pension funds can take advantage of it and minimise the risks associated with such exposure**

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see it as a standalone asset class, "in the sense that it can contribute to the building of a portfolio".

"If you compare currency to other asset classes it stands out in several ways. For example, compared to equities or bonds there are much fewer individual components to take positions in which is a negative. On

the other hand it is very liquid, which is a positive since it makes large position sizes possible," he explains.

In contrast, Aon Netherlands senior investment consultant, Thierry Rozier, does not think Dutch pension schemes see currency as an asset class in its own right. This is because in general, he says, Dutch pension funds see currency risk as unrewarded risk. However, this does not mean that schemes do not have any currency management strategies.

### **Risk management strategies**

"As you would imagine, pension funds are involved in currency management to varying degrees," Record Currency Management CEO, Leslie Hill, notes. "On the risk management side there are those at one end of the spectrum who believe that currency will 'come out in the wash' in the long term and so they choose not to hedge their foreign currency exposures."

"Others see the short- and medium-term volatility that currency introduces into their portfolio as highly undesirable and therefore choose to hedge some (or all) of

their risk, either passively or actively,” she adds.

Rozier says that many Dutch pension funds choose to hedge fully or part of the risk caused by currency exposure. “It is a strategy for risk management and a lot of pension funds with low funding levels choose to fully hedge the exposure. This is mainly on the US dollar, British pound and the Japanese yen,” he notes.

Whereas, von Essen says AP7 does not see the need to apply a static currency hedge to its investments as the fund is a long-term owner and its assets are highly yielding, he says.

“AP7 monitors currency exposure derived from investments but does not apply a static currency hedging programme since we believe that, over the longer term, that will cost more than it will give in return. We therefore normally run 100 per cent open currency risk in our fund. If we think a particular currency exposure warrants hedging due to mispricing or other issues such as political risk, we can do that.”

Whatever a pension fund’s opinion, however, in the current economic climate with the effects of the Covid-19 pandemic weighing down on schemes, it may be useful to have some kind of currency risk management strategy.

Shinohara states: “As with equities, the Covid-19 pandemic has elevated foreign exchange (FX) volatility to high levels at great speed. International equity portfolios have been especially susceptible to this elevated risk as both the equity and currency components have been extremely volatile.

“In times of crisis, correlations can break down and relationships can become uncertain, highlighting the need for having a currency risk policy in place before such an event occurs.”

### Return-seeking strategies

When it comes to return-seeking strategies, Hill says that it is many of the larger and sophisticated pension funds that adopt such approaches. “These funds either have an explicit allocation to currency strategies within their strategic asset allocation, or they incorporate currency into portfolios such as a larger multi-asset risk factor portfolio, or absolute-return portfolios.”

When it comes to searching for alpha, Rozier believes currency has a limited role within actively-managed bond or equity portfolios with currency management as an overlay. Using overlays is something that AP7 has been doing for more than a decade, von Essen adds.

“At AP7 we have been implementing unfunded strategies, as overlays to our long-only portfolio, for more than 10 years and currency has always been a part of that. We see currency exposure as a risk that we need to monitor, as well as a space where we can earn alpha from the markets.”

Explaining in more detail how pension funds can use currency as part of a return-seeking function, Shinohara says: “Currency factor strategies and currency alpha strategies can add return while helping to diversify the fund’s portfolio. Factor strategies typically exploit the well-known factors of carry, value, and momentum to represent currency.

“Currency alpha strategies cover a wide range of styles, from fundamental to technical to discretionary, where skilled managers can exploit opportunities in a market predominantly made up of passive price-takers. Currency-return strategies are highly liquid and tend to be uncorrelated to the major asset classes, making them an effective diversifier within a fund’s portfolio.”

### Costs

In terms of cost, Record Currency Management global head of sales and head of client team, Sally Francis-Cole, says trading costs are typically the main type associated with running a currency programme.

“If not well-managed and monitored, the cost of poor execution can quickly become disproportionately high. As such, it is important for pension funds to have clarity and transparency around costs and charges across their entire portfolio. This is particularly true in currency as the main costs are often implicit in the rate at which a transaction is carried out, as opposed to explicit commissions or charges, and can be hidden away in obscure benchmarks and difficult to pinpoint easily,” she adds.

For example, while the overall transaction costs of a currency hedging portfolio should be in the low single digit basis points, small slippage in execution (eg 2 bps) can quickly accumulate in a programme that rolls 12 times a year using monthly contracts (eg 12 x 2 bps = 24 bps p.a.).

“Another cost is obviously the management fees paid directly to the asset manager. Here it is important to look for managers who offer value for their service, and this doesn’t always mean the managers who will perform the service at the lowest fee. Often this means finding managers who focus on minimising costs and maximising value; these managers are often the most innovative and the quickest to respond to and exploit the ever-changing landscape of the FX markets,” Francis-Cole adds. ■

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